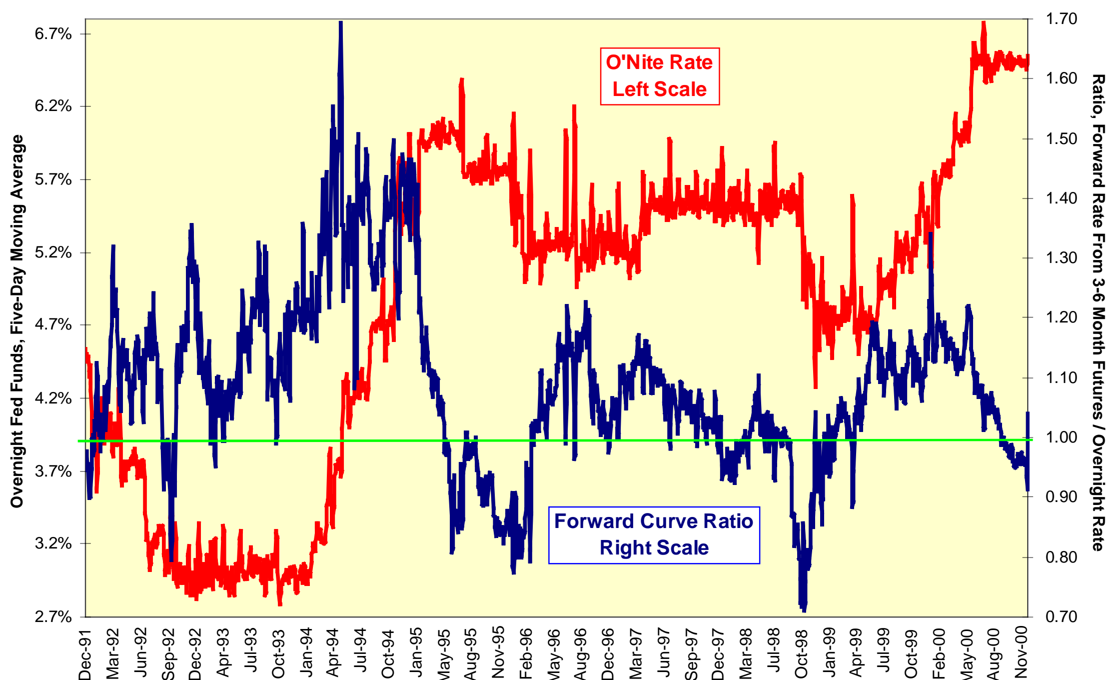
Economies Don't Land. Markets Do.

What if the cavalry rode to the rescue during the height of battle and then veered off at the last minute to the nearest tavern to down a few cold ones and play a little stud poker before deciding upon its proper course of action? Substitute Alan Greenspan for John Wayne, and that's what we've got going on today.

There are times to equivocate and times to declare. Let's declare, simply and forcefully: The Federal Reserve is going to cut rates to undo their previous damage, much like the pyromaniac who later graciously volunteers his services to the local fire department. What's the evidence for such certainty, you ask? The federal funds futures at the Chicago Board of Trade do an excellent job of measuring the market's sentiments. If we take the forward rate between the three- and six-month futures contracts and compare it to a five-day moving average of the overnight rate, (the overnight rate is an exceptionally noisy indicator and requires smoothing to make useful comparisons) we find the market began pricing out future rate hike in mid-May 2000, just before the sixth and last Fed rate hike. The fed funds futures began pricing in an actual rate cut at the end of August 2000, the exact time of the market's secondary peak. Both the equity and interest rate markets saw the same thing at the same time, a far rarer confluence of insight than we might believe.

The rate of declining interest rate expectations has not been as abrupt as it was in early 1995, in the aftermath of the Mexican devaluation, nor as abrupt as it was in 1998 during the Russian crisis. The Fed's own hawkish rhetoric has contributed to this hesitation. Rate cuts during the previous periods led to sharp stock rallies as both the Fed and foreign central banks added liquidity to a strong U.S. economy.

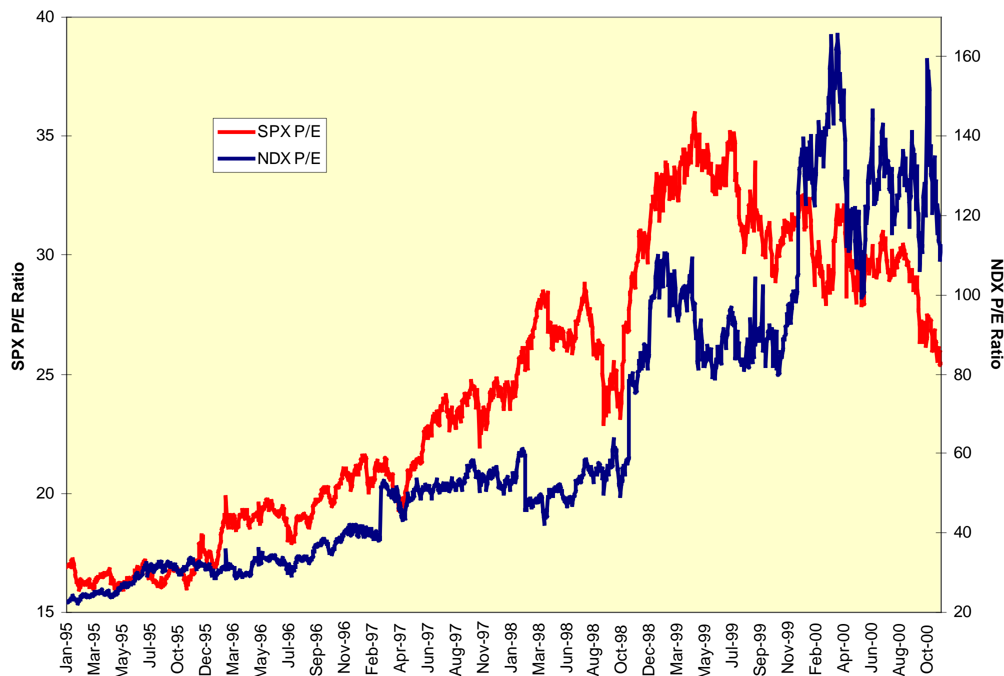


Let's be declarative once again. A rate cut now won't work as well as intended and for the same grim reasons that seven rate cuts by the Fed during the 1930-1931 period didn't work, and that the Bank of Japan's lowering of interest rates to near-zero levels during the 1990's didn't work. Lower interest rates cannot make people buy what they don't feel they'll need or will be able to profit therefrom; this is the "liquidity trap" described by Keynes and Hicks in 1937. When any asset price bubble is burst (challenge to

skeptical readers – show me how to let the air out of a balloon slowly using only a pin) it takes years, not days, weeks, or months, to undo the economic damage.

Why? The U.S. and indeed global economies maniacally reallocated resources toward the emerging Internet economy over the past few years, and not without reason. Most of the poster children for this Brave New World, we now know to our regret, won't make it, and this will damage the future sales prospects even of those "good girls" of the Internet, such as Sun Microsystems, Cisco Systems, and Oracle. The explosive growth of personal computer capacity has slowed the product replacement cycle as many customers concluded they have all of the hardware they'll need for a while. That hurts box assemblers like Gateway and Dell, chipmakers like Intel, and software providers like Microsoft.

The hangover from this party is going to be much rougher on the market, especially the NASDAQ, than on the economy as a whole. Much of the share price growth during the boom came not from lower interest rates or increased earnings, but from multiple expansion. Investors simply were willing to assume a greater level of risk, and were rewarded handsomely for doing so.



It's interesting to note that trailing P/E's on the S&P 500 peaked on April 12, 1999 at 35.97, about six weeks before the Fed's first rate hike. The index closed at 1358.63 that day; on December 1, 2000, it closed at 1315.23, with a trailing P/E of 25.47. Similar numbers for the NASDAQ 100 are a peak trailing P/E of 165.4 on March 24, 2000 with the NDX at 4691.61; at present, the index is at 2549.74 with a P/E of 112.3.

Once interest rates rose, risk seeking diminished in the SPX, and has continued to decline even as the interest rate outlook improves. The NDX is still turbo-charged: Its current P/E is higher than it was at any time before December 20, 1999. This suggests those who are looking for a quick tech-led rebound are likely to be disappointed, the market is already priced at aggressive levels even though its price has been chopped in half in less than nine months. More traditional value and cyclical issues are unlikely to rally until evidence of an economic rebound is at hand.

What will people do with a Fed rate cut? In times of uncertainty, traditional saving in deposit instruments, debt reduction and other conservative strategies start to look good. Will they go back to what worked last year? Not without the cavalry.